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## Unreasonable Reliance: Fiduciary Duty after the Court of Appeals' Pappas Decision

Nearly a century ago, Justice Cardozo authored those now famous words for the Court of Appeals describing a fiduciary duty:

Joint adventurers, like copartners, owe to one another, while the enterprise continues, the duty of the finest loyalty. ... A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate.<sup>1</sup>

Since then, that edict has been cited in countless motions and decisions where one business partner is charged by another with violating his or her fiduciary duties, including the duties of undivided loyalty and against self-interest.<sup>2</sup>

In a recent decision in *Pappas v. Tzolis*,<sup>3</sup> however, the Court of Appeals discusses a situation where the fiduciary relationship was not so "unbending and inveterate" based on a disagreement between the business partners.

### The Operating Agreement

The facts in *Pappas* should sound very familiar, as they describe a situation often encountered in commercial leasing and litigation.

In 2006 Plaintiffs Steve Pappas and Constantine Ifantopoulos and defendant Steve Tzolis formed a business, Vrahos LLC, for the specific purpose of entering into a long-term lease on a building in Manhattan. Pappas and Tzolis each contributed \$50,000 and Ifantopoulos contributed \$25,000 to Vrahos in exchange for proportionate shares in the company.

In January 2006 the parties entered into an operating agreement to govern their business relationship. Pursuant to

the operating agreement, Tzolis agreed to post and maintain the required security deposit for the lease on the consideration that he was also permitted to sublet the property from Vrahos. The operating agreement further required that Tzolis, as the subtenant, pay additional monies to Vrahos above the rental payments Vrahos was required to pay to the overlandlord.<sup>4</sup>



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The operating agreement also contained what would later turn out to be another very important clause:

Any Member [of Vrahos] may engage in business ventures and investments of any nature whatsoever, whether or not in competition with the LLC, without obligation of any kind

to the LLC or to the other Members.

### Disagreement and Distrust

In June 2006, Tzolis exercised his right to sublease the building and caused Vrahos to enter into a sublease with a company he owned independent from Pappas. Pursuant to the operating agreement, the sublease required Tzolis's company to pay Vrahos \$20,000 per month in addition to the rent payable by Vrahos under the prime lease.

Pappas, however, claimed that he "reluctantly agreed to [the sublease with Tzolis's company] because they were looking to lease the building and Tzolis was obstructing this from happening," presumably so he could sublease the building himself.<sup>5</sup> Specifically, Pappas, who allegedly wanted to sublease the building to others, claimed that Tzolis "not only blocked [Pappas'] efforts, he also did not cooperate in listing the Property for sale or lease with any New York real estate brokers."

Moreover, Pappas claimed that Tzolis "had not made, and was not diligently

preparing to make, the improvements ... required to be made under the Lease. Tzolis was also refusing to cooperate in [Pappas's] efforts to develop the Property." Finally, Pappas alleged that Tzolis's company was not paying the additional rent payments to Vrahos pursuant to the sublease and the operating agreement.

### Buyout – and Betrayal?

A few months after the subtenancy began, Tzolis suggested to plaintiffs that they assign their interests in Vrahos to him. Tzolis claimed that he did not want to make the additional rent payments to Vrahos and would rather take over the prime lease.

Plaintiffs agreed and negotiated buyouts of \$1,000,000 for Pappas and \$500,000 for Ifantopoulos, or 20 times what they had initially paid for their interests in Vrahos. At the closing in January 2007, Pappas and Ifantopoulos signed an Agreement of Assignment and Assumption, as well as a handwritten "certificate" providing that they had performed [their] own due diligence in connection with [the] assignments. ... engaged [their] own legal counsel, and [were] not relying on any representation by Steve Tzolis, or any of his agents or representatives, except as set forth in the assignments & other documents delivered to the undersigned Sellers today, [and that] Steve Tzolis has no fiduciary duty to the undersigned Sellers in connection with [the] assignments.

Six months after the closing, Vrahos, now wholly owned by Tzolis, assigned its lease to a non-party, Extell Development Company, for \$17,000,000.

### The Rulings Below

After learning of Tzolis's assignment of the lease, Pappas and Ifantopoulos commenced an action claiming that Tzolis

breached his fiduciary duty to them by failing to disclose his negotiations with Extell. Pappas and Ifantopoulos alleged that Tzolis had surreptitiously negotiated the lease assignment to Extell while simultaneously negotiating the purchase of their interests in Vrahos. In all, Pappas and Ifantopoulos asserted eleven causes of action stemming from Tzolis's alleged failure to disclose his dealings with Extell, including a breach of his fiduciary duties.

Tzolis moved to dismiss the complaint in its entirety arguing that he and plaintiffs never intended to enter into a fiduciary relationship and that he had no duty to disclose his negotiations with Extell. The trial court agreed, finding that the operating agreement "eliminates the fiduciary relationship that would, otherwise, be owed by the members to each other and to the LLC."

The trial court also found that the Certificate negated any claim of reliance on any superior knowledge that Tzolis may have had about the property. A divided panel of the Appellate Division, First Department modified the ruling and allowed certain of plaintiffs' claims to proceed, including their claim for breach of fiduciary duty.

### The Court of Appeals Decision

The Court of Appeals reversed the Appellate Division and agreed with the trial court's ruling dismissing the breach of fiduciary duty claim. In support of its decision, the Court of Appeals relied solely upon its decision from a year earlier in *Centro Empresarial Cempresa S.A. v. América Móvil, S.A.B. de C.V.* in which the Court held that "[a] sophisticated

principal is able to release its fiduciary from claims – at least where ... the fiduciary relationship is no longer one of unquestioning trust – so long as the principal understands that the fiduciary is acting in its own interest and the release is knowingly entered into."<sup>6</sup>

The Court went on to say in *Pappas* that "[t]he test, in essence, is whether, given the nature of the parties' relationship at the time of the release, the principal is aware of information about the fiduciary that would make reliance on the fiduciary unreasonable." From this, the Court found that plaintiffs' claimed reliance on Tzolis to disclose any negotiations with third-parties for an assignment of the lease was negated by the Certificate and the circumstances concerning their business relationship.

Specifically, the Court found that Tzolis had no fiduciary duty to disclose any such negotiations because the relationship between plaintiffs and Tzolis had soured prior to the closing, as evidenced by "numerous business disputes" concerning the sublease arrangement, including disagreements about the sublease. Consequently, the Court continued, plaintiffs could no longer regard Tzolis as "trustworthy."

Given this, as well as the fact that the parties were sophisticated businessmen who were represented by counsel when they signed the Certificate and substantial increased price paid by Tzolis for plaintiffs' interests in Vrahos, the Court found that the release language contained in the Certificate was valid and, therefore, prohibited plaintiffs' breach of fiduciary duty claim.

### Lessons from the *Pappas* Decision

The Court of Appeals decision in *Pappas* offers guidance to practitioners on potentially limiting a client's fiduciary duties to a business partner through contract and circumstances. However, the decision may have a much more significant impact on litigation than anticipated, as the disputes between Pappas and his business partners were not dissimilar from the typical disagreements that arise between business owners.

Although the context of *Pappas*, as in *Centro Empresarial Cempresa*, is a buy-out of one partner's interest in a business by another, it is not clear from the Court's analysis if the logic of the case would impact the fiduciary duties owed in other non-buyout contexts. Business owners, and their attorneys, therefore, must take heed of the decision in *Pappas*, as it may impact the level of trust one may repose is a business partner following a disagreement about the operation of their business.

At the very least, the decision in *Pappas* should guide practitioners in drafting complaints in which a breach of fiduciary duty claim is alleged, as the inclusion of excessive allegations concerning disputes between the parties may undermine such a claim.

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1. *Meinhard v. Salmon*, 249 N.Y. 458, 464 (1928).
2. A Lexis Shepard's Report shows more than 2,500 citing references to the decision in *Meinhard v. Salmon*.
3. 20 N.Y.3d 228 (2012).
4. See *Pappas v. Tzolis*, 87 A.D.3d 889 (1st Dept. 2011).
5. *Pappas*, 20 N.Y.3d at 231.
6. 17 N.Y.3d 269, 278 (2011).



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